No. 13,097

IN THE

United States Court of Appeals

For the Ninth Circuit

CHARLES A. CRISPIN and ALMA B. CRISPIN,
Appellants,

vs.

UNITED STATES OF AMERICA,
Appellee.

Appeal from the United States District Court for the Northern District of California, Southern Division.

APPELLANTS' OPENING BRIEF.

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STATEMENT RESPECTING JURISDICTION.

This is an action by the United States against appellants under the provisions of Internal Revenue Code Section 3746(a). It was instituted in the United States District Court for the Northern District of California. The cause of action alleged was for the recovery of assertedly erroneous refunds of income tax made to appellants on October 13, 1947 and February 11, 1948. The complaint was filed on October 13, 1949. (R. 3-5.) An answer was filed on October 21, 1949. (R. 5-6.)

Judgment was entered for plaintiff on June 20, 1951. The notice of appeal was filed, pursuant to Rule

73(a) of the Federal Rules of Civil Procedure, on August 15, 1951. (R. 16.)

Appellants reside in Los Gatos, California. (R. 10.)

STATEMENT OF THE CASE.

The facts in this case are as follows:

Appellants are United States citizens, now residing in Los Gatos, California. (R. 6, 10.) Prior to January 1, 1941, they were residents of China. (R. 6, 11.) Appellant Charles A. Crispin was employed in China by Standard-Vacuum Oil Company until his retirement on January 1, 1941. (R. 6-7, 11-12.)[1] He participated in a retirement plan of his employer under which an annuity contract was purchased for him from the Metropolitan Life Insurance Company. (R. 6-7, 11-12.) Appellant contributed $2,156.00 toward the cost of this annuity, and his employer contributed $30,631.68. (R. 6, 11.) The contributions to the cost were paid in annual installments and were completed by September 17, 1940. (R. 6-7.) Appellant became eligible to retire on September 17, 1940, and under the terms of the annuity contract his rights thereto became fixed and nonforfeitable on that date. (R. 7, 11-12.)

In each of the years 1943 and 1944, appellant received $2,869.32 as an annuity under the annuity con-

[1]Appellant Alma B. Crispin is involved because she and Charles filed joint returns. All the facts relate to Charles. Therefore we shall hereinafter refer to Charles simply as "appellant".

tract. (R. 7, 12.) The full amount of these receipts was included as income in appellants' joint return and a tax was paid thereon. (R. 7, 12.) Refund claims were later filed and refunds were made to them in the amount of $318.19, including interest, for 1943, and $296.58, including interest, for 1944. (R. 12-13.) Within two years thereafter, the United States instituted this action for the recovery of those refunds. (R. 3-5.) Judgment was entered for the United States and within sixty days defendants filed their notice of appeal. (R. 15-16.)

The issues involved on this appeal are of law. The Court below misinterpreted Internal Revenue Code Sections 22(a), 22(b)(2)(A), and 116(a), and entered a judgment for plaintiff which is not supported by the findings of fact.

SPECIFICATIONS OF ERROR.

1. The District Court made an error of law in holding that the aggregate consideration paid for appellants' annuity, for the purposes of Internal Revenue Code Section 22(b)(2)(A), does not include the consideration paid for that annuity by the employer, Standard-Vacuum Oil Company. (R. 19.)

2. The District Court made an error of law in failing to hold that the cost of appellants' annuity for purposes of Internal Revenue Code Section 22(b)(2)(A), referred to therein as "aggregate consideration paid," was the sum of $32,787.68. (R. 19.)

SUMMARY OF ARGUMENT.

When appellant returned to the United States in 1941, he owned an annuity contract. His rights under it had become fixed and nonforfeitable in the prior year, when he was still a nonresident of the United States. He had earned that annuity contract by his services performed for his employer while he was a nonresident, and complete ownership of the contract vested in him while he was a nonresident.

In these circumstances, the receipt by appellant of the annuity contract constituted additional compensation to him, and therefore was income. However, the income became his while he was a nonresident and therefore was not taxable under Internal Revenue Code Section 116(a). It should not be taxed to him in a subsequent year.

Internal Revenue Code Section 22(b)(2)(A), which governs the taxation of annuity receipts, does not attempt to tax appellant on income which became his while he was an exempt nonresident. It does not tax so much of each year's receipts as merely constitute a return of the "aggregate * * * consideration paid for such annuity," and it has been recognized that the employer's contributions are part of the "aggregate * * * consideration paid" wherever those contributions or what they purchased became income to the annuitant. Since that is the case here, appellant is not taxable on so much of the receipts after his retirement which are merely a payment to him of his employer's contributions.

ARGUMENT.

I. APPELLANT'S ANNUITY RECEIPTS ARE TAXABLE AS PROVIDED IN INTERNAL REVENUE CODE SECTION 22(b)(2)(A).

Appellant received $2,869.32 in 1943 and an identical amount in 1944 under an annuity contract with Metropolitan Life Insurance Company. (R. 11-12.) The cost of the contract was $32,787.68, of which appellant paid $2,156.00 and his employer paid $30,631.68. (R. 11.) These payments had been made in annual installments over a period of years up to and including 1940 during appellant's employment abroad. (R. 6,11.)

Annuity receipts are taxable as provided in I.R.C. Section 22(b)(2)(A) and (B) [Appendix, infra, pp. ii, iii, iv]. Subdivision (B) thereof has no application to this case, because it is part of an elaborate statutory plan which was not enacted until 1942 and which is without application to annuity contracts which vested in the employee before that date. *Hackett v. Commissioner* (1946, C.A. 1), 159 F. 24 (2d) 121, 125; *Oberwinder v. Commissioner* (1945, C.A. 8), 147 F. (2d) 255, 259; Revenue Act of 1942, Sec. 162(d). Moreover, on its face subdivision (B) has no application to annuities where the employer's contribution was not deductible under Section 23(p)(1)(B), a provision not in existence prior to 1942, except where the employer is exempt under Section 101(6). Therefore subdivision (A) is the controlling provision.

Subdivision (A) establishes the so-called 3 per cent rule. Under this rule, the yearly annuity receipts are treated as taxable income each year only to the ex-

tent they equal 3 per cent of the "aggregate premiums or consideration paid for" the annuity, and the remainder of the annual annuity receipts are treated as non-taxable return of capital. When the total of the amounts so excluded from tax as return of capital "equals the aggregate premiums or consideration paid for such annuity", the remaining annuity receipts become fully taxable.

The dispute here is whether the "aggregate premiums or consideration paid for such annuity" are $32,787.68 as contended by appellant, or are only $2,156.00, as appellee contends. This in turn depends on whether the portion of the "aggregate * * * consideration" paid by the employer is includible in the quoted term. Appellant's position is that the employer's contributions are includible in that term. If appellant is wrong, then by 1943 and 1944 he had entirely recovered his cost and the entire annuity receipts of those years are taxable. If appellant is right, $983.63 of each year's annuity receipts is taxable income and the balance is excludible as a return of capital. In this event, the refunds were proper and not erroneous, and judgment below should have been for appellant.

II. THE EMPLOYER'S CONTRIBUTIONS TO THE PURCHASE PRICE OF THE ANNUITY ARE PART OF THE "AGGREGATE CONSIDERATION" UNDER SECTION 22(b)(2)(A).

As noted in the previous division of this brief, this case revolves about the question whether the employer's contributions to the cost of the annuity contract

are included within the phrase "aggregate premiums or consideration paid for such annuity," under I.R.C. Section 22(b)(2)(A).

1. Textually, of course, the quoted term is sufficiently broad to include the employer's contributions regardless of the circumstances in which they were made. The "aggregate * * * consideration" means the total consideration paid for the annuity, which in this case is $32,787.68. The question immediately arises whether this ends the matter.

While the language of the statute is unqualified and speaks of no exceptions, it has been held that some exceptions should be read into it. In *Charles L. Jones v. Commissioner* (1943), 2 T.C. 924, the Tax Court held, after consideration of the legislative history of this provision, that the term "aggregate * * * consideration" included contributions of the employer in the nature of compensation only where the employee had been in receipt of income on account of those contributions. We need not challenge that decision to prevail here, as we shall demonstrate. It is not correct to conclude, as the Court below evidently did, that because this qualification exists the instant case is disposed of.

2. The payment by the employer of the bulk of the purchase price for this annuity contract was either a gift to appellant or was additional compensation. The findings do not disclose which it was.[2] If it was a

[2]This action is by the United States for the recovery of an erroneous refund, under I.R.C. Sec. 3746(a). The statute gives the government none of the usual assistance, such as presumptions in its

gift, the employer's contribution is part of the "aggregate * * * consideration." This is the settled rule. *MacArthur v. Commissioner* (1948, C.A. 8), 168 F. (2d) 413; *Title Guarantee & Trust Co.* (1939), 40 B.T.A. 475, 482. Indeed, the rule could not be otherwise. The purpose of the 3 per cent rule is to isolate and tax the interest element in the annuity receipts and to permit the annuitant's capital to return to him untaxed. Capital acquired by gift is recognized as capital for income tax purposes. Section 22(b)(3); Section 113(a)(2). Accordingly, as the cited cases hold, a donor's contribution to the cost of an annuity contract is part of the "aggregate * * * consideration paid for such annuity."

3. If the employer's contributions were not a gift to appellant, it is because they were additional compensation for services rendered. We do not argue that they were a gift. We think they were compensation for services, and would be construed to be so even under *Bogardus v. Commissioner* (1937), 302 U.S. 34, and certainly so under *Commissioner v. Smith* (1945), 324 U.S. 177. Cases such as *Oberwinder v. Commissioner* (1945, C.A. 8), 147 F. (2d) 255, 258, and *Hackett v. Commission* (1946, C.A. 1), 159 F. (2d) 121, 123, treat the purchase of annuity contracts by the employer for the employee as additional com-

favor. The United States, being plaintiff, therefore has the burden of proof. *U. S. v. Wood* (1935, CA 3), 79 F.2d 286, 287; *U. S. v. Brown, Inc.* (1938, S.D. N.Y.), 22 A.F.T.R. 1249, 38-1 USTC 9131; *Group No. 1 Oil Corp. v. Thomas* (1943, N.D. Tex.), 32 A.F.T.R. 1663, 43-1 USTC 9448. Therefore the penalty for any informity in the findings is on appellee.

pensation as a matter of law. In view of the *Smith* case, we do not see how that understanding can be questioned. Accordingly, we do not argue that the employer's contributions were a gift.

However, the Courts have recognized that where the employer's contributions to the purchase price of the annuity contract constitute additional compensation to the employee, they become part of the "aggregate premiums or consideration paid for such annuity" under Section 22(b)(2)(A). In *Hackett v. Commissioner* (1945), 5 T.C. 1325, 1331-1333, affirmed (1946, C.A. 1), 159 F. (2d) 121, 123-125, both the Tax Court and the Court of Appeals for the First Circuit so held. In *Freeman v. Commissioner* (1945), 4 T.C. 582, the Tax Court so held without an appeal being taken. Even *Jones v. Commissioner,* discussed both above and in the succeeding division of this brief, which is the case relied on below, recognizes this much.

The only qualification which can exist to this rule is in such circumstances as to render the additional compensation not properly includible in the income of the employee. This could be the situation only where the employee never received ownership of fixed, nonforfeitable rights to the additional compensation. If, for example, the payments by the employer are applied to purchase a contract as to which the employee's rights are entirely contingent on his remaining in the employ for a specified number of years, it can be said that the employee receives no income from the employer's payments, *at that time.* But when the con-

tingencies are removed and the employee's ownership vests, he has received the additional compensation. At that point there is no longer any basis for excluding the employer's contributions to the cost of the contract from the "aggregate * * * consideration paid."

Accordingly, the law can be taken to be that the employer's contributions to the purchase price of the annuity contract are part of the "aggregate consideration" for purposes of Section 22(b)(2)(A) if the employees received them as additional compensation so that they entered into his income, either when they were paid or when his rights to what they bought became fixed and nonforfeitable.

As we shall now demonstrate, appellant received income from his employer's contributions no later than 1940, when he acquired fixed, nonforfeitable ownership of the property they had purchased.

III. THE ANNUITY CONTRACT BECAME INCOME TO APPELLANT NO LATER THAN 1940.

Section 22(a), I.R.C. [Appendix, infra, p. i], defines gross income in the broadest possible terms,[3] and specifically includes the following:

> "* * * compensation for personal service * * * of whatever kind and in whatever form paid, * * *."

[3]It has been said that this definition is as broad as the meaning of "income" in the Sixteenth Amendment itself. *Helvering v. Clifford* (1940), 309 U.S. 331, 334; *Helvering v. Stuart* (1943), 317 U.S. 154, 169.

Words could not be plainer, and consistently with their clarity and scope the Courts have held that compensation for personal services is taxable income even though received in all sorts of unusual forms.

Examples of the broad sweep of this rule, to be found in the cases, are these: the rental value of a dwelling occupied by a corporate officer is taxable as compensation for services (*Chandler v. Commissioner* (1941, C.A. 3), 119 F. (2d) 723; *Dean v. Commissioner* (1947), 9 T.C. 256, 267); the value of the use by the employee of the employer's automobile for personal pleasure is compensation for services which is properly includible in the employee's income (*Rodgers Dairy Co. v. Commissioner* (1950), 14 T.C. 66, 73-74); the payment to the United States by the employer of the employee's income taxes is additional compensation taxable as income of the employee (*Old Colony Trust Co. v. Commissioner* (1929), 279 U.S. 716); the payment by the employer of premiums on insurance policies taken out by the employer on the life of the employee is income to the employee wherever the employee or his family is named as beneficiary[4] (*Commissioner v. Bonwit* (1937, C.A. 2), 87 F. (2d) 764, cert. den. 302 U.S. 694; *Canady v. Guitteau* (1936, C.A. 6), 86 F. (2d) 303; *Yuengling v. Commissioner* (1934, C.A. 3), 69 F. (2d) 971; *Adams v. Commissioner* (1929), 18 B.T.A. 381; *Danforth v. Commissioner* (1929), 18 B.T.A. 1221); sums withheld from the em-

[4]This statement has been held not to apply to group life insurance, since it is taken out without the consent or participation of the employee. *Adams v. Commissioner* (1929), 18 BTA 381, 383, 384.

ployee's salary under statutory authority and without his consent and paid to a retirement fund for application to his account are income to the employee (*Miller v. Commissioner* (1944, C.A. 4), 144 F. (2d) 287). This rule has even been carried to the point where the saving on the purchase of stock pursuant to an option is taxable as income from personal services where the option was granted as compensation for personal services (*Commissioner v. Smith* (1945), 324 U.S. 177). The Supreme Court, in this last case, said (324 U.S. 18):

> "Section 22(a) * * * is broad enough to include in taxable income any economic or financial benefit conferred on the employee as compensation, whatever the form or mode by which it is effected." (Citing *Old Colony Trust Co. v. Commissioner*, cited above.)

In view of these indications of the broad sweep of the rule, it is hardly surprising that the receipt by an employee of property rights, in the form of annuity contracts, paid for by the employer, has been held to give rise to taxable income. Any other result would be an insupportable departure from the rule of the statute as exemplified by the foregoing cases. Accordingly, we find that the value of annuity contracts purchased by the employer for the employee has been held taxable to the employee in the year his ownership of the contracts became fixed and nonforfeitable. *Oberwinder v. Commissioner* (1945, C.A. 8), 147 F. (2d) 255; *Hubbell v. Commissioner* (1945, C.A. 6), 150 F.

(2d) 516; *Hackett v. Commissioner* (1946, C.A. 1), 159 F. (2d) 121; *Ward v. Commissioner* (1947, C.A. 2), 159 F. (2d) 502; *U. S. v. Drescher* (1950, C.A. 2), 179 F. (2d) 863, cert. den. 340 U.S. 821; *Deupree v. Commissioner* (1942), 1 T.C. 113; *Brodie v. Commissioner* (1942), 1 T.C. 275; *Freeman v. Commissioner* (1945), 4 T.C. 582.

The earliest of these cited cases is the *Deupree* case, and because of its facts it well serves as an introduction to this particular area. Mr. Deupree was a participant in his employer's profit sharing plan. In the taxable year, he directed that his share be used by the employer to buy for him a single premium, nonassignable annuity contract with no provision for surrendering it. This was done. The purchase price of the annuity was held taxable to him, notwithstanding the restrictions on the surrender or assignment of the annuity contract, because his rights were nonforfeitable. The case is thus similar to *Miller v. Commissioner,* supra (1944, C.A. 4), 144 F. (2d) 287.

The cases have proceeded beyond the point of the *Deupree* case. They have held that the receipt by the employee of fixed, nonforfeitable ownership of an annuity contract paid for, in whole or in part, by his employer, constitutes income even where the taxpayer did not have the option to receive cash instead of the contract as he did in the *Deupree* case. *Brodie v. Commissioner* (1942), 1 T.C. 275, so held, and the remainder of the cases listed above are to the same effect.

There are two general methods by which annuity contracts may be purchased: by a single premium or by several annual premiums. The cases have held that the receipt by the employee of a fully paid up single premium annuity contract, purchased by his employer, constitutes taxable income to him, provided his rights under the annuity contract are nonforfeitable. *Brodie v. Commissioner,* supra; *Oberwinder v. Commissioner* (1945, C.A. 8), 147 F. (2d) 255; *Hackett v. Commissioner* (1946, C.A. 1), 159 F. (2d) 121; *Ward v. Commissioner* (1947, C.A. 2), 159 F. (2d) 502; *U.S. v. Drescher* (1950, C.A. 2), 179 F. (2d) 863; *Freeman v. Commissioner* (1945), 4 T.C. 582. In many of these cases the annuity contract was not assignable. See *U. S. v. Drescher,* supra. The important factor stressed in these cases is that the receipt of a nonforfeitable annuity contract is the receipt of a vested economic benefit, which is income just as much as if it were a bond, a block of stock or cash. The fact that payments under the annuity will not begin until some date in the future has no more significance than would the fact a bond, received as compensation, was not due until 1962. As was emphasized in the *Oberwinder* case (147 F. (2d) at 259), and the *Hackett* case (159 F. (2d) at 124), the important thing is that the valuable economic rights received by the employees were nonforfeitable.[5]

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[5]We have not found any case in which this Court has considered this area of the law. The nearest approach to it is *Wolfe v. Commissioner* (1948, CA 9), 170 F. 2d 73, cert. den. 336 U.S. 914, affirming without opinion 8 T.C. 689. However, this case did not deal with annuity contracts but involved a funded but apparently revocable promise of the employer. It is therefore inapposite here.

There is no reason in principle or in the statute why the same rule should not be applied to annuity contracts purchased by several annual premiums. The rights received by the employee are the same in either case, and their value, once they become nonforfeitable, will be the same in either case. From the viewpoint of the employee, he is clearly enriched equally in either case, and the method used by his employer in paying for the contract is irrelevant to (1) the fact of his enrichment and (2) the extent of his enrichment.

To illustrate the point, consider the case of an employee for whom the employer agreed to buy a house as additional compensation. If the employer pays the entire purchase price of the house in one lump sum and at once deeds the house to the employee without reservation or restriction, there is no doubt that the receipt of title to the house by the employee is taxable income to him. Suppose instead, however, the employer agrees to buy the house in ten annual installments and, if the employee is still in the employer's service when the house is fully paid for, to deed it to him then. Is it not entirely clear that here too the house constitutes income to the employee when he receives title to it?

This analysis is equally applicable to a bond purchased by the employer for the employee. The delivery to the employee of fixed, nonforfeitable ownership of the bond is the taxable event on which he realizes income, whether the employer purchased the bond in a single lump sum or in annual installments.

The analysis concerning the house and the bond is equally applicable to annuity contracts. In 1940 there was no special provision in the Internal Revenue Code governing the taxability of annuity contracts purchased by employers for employees, and the provisions added in 1942 were not retroactive. *Hackett v. Commissioner,* supra, 159 F. (2d) at 125; *Oberwinder v. Commissioner,* supra, 147 F. (2d) at 259; Revenue Act of 1942, Sec. 162(d).

The Court below, however, decided differently, on the authority of *Jones v. Commissioner* (1943), 2 T.C. 924, supra. There was no attempt below to meet the foregoing analysis or to explain why different considerations should govern the receipt of one type of compensation than governs the receipt of all others. There was merely a mechanical application of the *Jones* case.

We do not quarrel with the justice of the *Jones* decision. But unless it is confined to its facts or interpreted differently than it was understood by the Court below, it is an example of how hard cases do indeed make bad law.

The first point to note in analysis of the *Jones* case is that it was decided before any of the decisions from the courts of appeals which are cited above. Therefore it was decided before the law had crystallized, as it now has, to the effect that the receipt by an employee of an annuity contract paid for in a single premium by the employer constitutes income to the employee. This point is important, because the Tax Court had difficulty making up its mind that this was the law,

and when the *Jones* case was decided the court was not certain that its then very recent *Brodie* decision would not be reversed.[6] Accordingly it was no time to expect the Tax Court to extend its *Brodie* decision.

The second point to note about the *Jones* case is that the taxpayer's principal argument was that the employer's contributions were part of the cost of the annuity contract which he was entitled to recover tax-free, *regardless* of whether or not the receipt of the annuity contract had been taxable income to the employee. The Tax Court rejected this contention at great length, and held that the employer's contributions were not part of the "cost" the employee is entitled to recoup unless the employee was taxable on those contributions when he acquired ownership of the annuity contract. We have no quarrel with this portion of the *Jones* decision.

If the *Jones* case is interpreted as being a considered decision on the point involved herein, however, we disagree with and ask this Court not to follow that portion of it. On that point, it cannot be reconciled with the *Oberwinder, Hubbell, Hackett, Ward,* and *Drescher* cases, all more recently decided by various courts of appeals.

Unlike the instant case, the *Jones* case involved a resident citizen who performed all his services for his

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[6]See the partial account of the Tax Court's meanderings on this subject in *Hubbell v. Commissioner,* supra, 150 F. 2d at 521. Furthermore, the Bureau's published rulings were contrary to the result reached in the *Brodie* case until 1951. Compare I.T. 1810 (II-2 CB 70) and I.T. 2891 (XIV-1 CB 50) with I.T. 4041 (1951-1 CB 5).

employer while a resident of the United States. His employer was the same as that of appellant herein, and the retirement plan was the same as that under which appellant herein has retired, although several changes were made in it after Jones retired and before Mr. Crispin did so. Jones became eligible to retire in 1934 and became the vested owner of his annuity contract in that year. Also in that year the employer paid 97 per cent of the cost price of the annuity contract. Jones' contributions were all refunded to him. 2 T.C. at 927. Accordingly, in 1934 the situation insofar as Jones was concerned was to all intents and purposes the same as if in that year the employer had purchased and delivered to him a single premium annuity contract. Accordingly, under the rule that has now been established, the annuity contract was taxable income of Jones in 1934,[7] and therefore was part of his cost which he was entitled to recover tax-free. The ultimate result reached by the Tax Court was contrary to this. Why?

In seeking to find the answer the Tax Court gave to this question, we find that Jones did not argue that he was taxable on the value of the annuity contract in 1934 when he received it. This is evident from the opinion of the Tax Court at page 931 of 2 T.C. where that court pointed out that neither party

[7]Jones did not report the receipt of the annuity contract in his 1934 income tax return. However, under Bureau rulings I.T. 1810 (II-2 CB 70) and I.T. 2891 (XIV-1 CB 50), issued in 1923 and 1935, respectively, he was not required to. The rulings were not formally overruled until 1951, in I.T. 4041 (1951-1 CB 5).

relied on the *Brodie* and *Deupree* cases (both supra), and added:

> "Whether a similar conclusion [as in the *Brodie* case] would have been justified if the Commissioner had attempted to include the amount expended by petitioner's employer in his gross income for the year 1934 is not before us."

The court then (2 T.C. at 934) concluded that the employer's contributions could not be a part of the cost of the annuity contract except where they had entered into the employee's income, and as can be seen Jones was not arguing that his case fitted into that exception.[8] We are, however, so that we are presenting an issue neither argued nor decided in the *Jones case.*[9]

The actual position taken by the Tax Court in its later decisions on the point we are arguing can be seen from *Freeman v. Commissioner,* supra (1945), 4 T.C. 582), and *Hackett v. Commissioner* (1945), 5 T.C. 1325, aff'd (1946, C.A. 1), 159 F. (2d) 121.[10]

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[8]Undoubtedly Jones' failure to argue that he should have been taxed in 1934 was due to I.R.C. Sec. 3801, which is retroactive to 1932, and under which the 1934 tax probably could have been collectible if held due.

[9]The other Tax Court case cited and relied on by the Court below, *Ella B. Higgs v. Commissioner* (1951), 16 T.C. 16, has nothing to do with this problem. It cited and followed the *Jones* case on another point decided in the *Jones* case, i.e., the cost basis allocable to the survivor feature in survivor annuities. The tax consequences of survivor provisions are not in issue herein.

[10]The Bureau has only this year brought its published rulings into line with the *Oberwinder, Hackett,* and other such cases. I.T. 4041, 1951-1 CB 5. Whether its indecision in adopting this position is what prompted its action in suing appellant is unknown, but seems a reasonable speculation.

See also *E. T. Sproull v. Commissioner* (1951), 16 T.C. 244, and *Hall v. Commissioner* (1950), 15 T.C. 195, where the same analysis—that for which we argue herein—was applied to compensation paid in property other than annuity contracts. The *Hall* case is especially close to that herein. Two stock certificates were put in escrow in 1942 by a corporate employer, one to be delivered to the employee in 1943 and the other in 1944 if the employee was still in the employ in those years. The employee received the certificates in 1943 and 1944, and was held to have received taxable income in those years. Reduced to its simplest terms, appellant's case is like the *Hall* case. He received income in 1940, when he received fixed and nonforfeitable ownership of the annuity contract.

IV. THE DECISION BELOW FAILS PROPERLY TO GIVE EFFECT TO THE EXEMPTION FROM TAX OF APPELLANT'S EARNINGS DURING THE PERIOD HE WAS A NONRESIDENT.

Section 116(a) of the Internal Revenue Code [Appendix, infra, pp. iv, v] exempts from tax the earnings from personal services of nonresident citizens of the United States. Appellant was a nonresident in 1940 when the annuity contract became income to him by reason of his rights to the contract having become fixed and nonforfeitable in that year. He was a nonresident also in the preceding years when he earned the annuity contract, through performing services for which the employer's contributions were made. (R. 6-7, 11.)

It is not our contention that Section 116 exempts appellant's annual annuity receipts. Section 22(b)(2)(A) is the section which has that effect, to the extent they are exempt. But Section 116 did exempt appellant's compensation received in 1940 and earlier years for his services performed while a nonresident. His basic salary, from which his own contributions to the "aggregate * * * consideration" were made, was exempt under Section 116(a). If his employer had contributed toward the cost of a series of single premium annuity contracts, these contracts, while income to him in the year of purchase, would have been exempt. If in 1940 the employer had paid appellant $30,000.00 in cash as additional compensation and appellant had used the funds to buy the annuity contract he owns, the $30,000.00 would have been income to him in 1940, but it would have been exempt from tax under Section 116(a).

The inflexible trend of decisions has been to treat the receipt of property the same as the receipt of cash, under Section 22(a). This case should be decided by the application of the same principles. The result which should be reached is the same as that which would be reached if appellant's employer had paid him an extra $30,631.68 in 1940 for the purpose of enabling him to buy an annuity, and he had bought it.

When appellant returned to the United States to live, one of his assets was the annuity contract. He owned it, without qualification. It was his capital. He had earned it and received it while a nonresi-

dent. To deny that its value then was capital to him is to deny what Section 116(a) manifestly was intended to grant—tax exemption on compensation for personal services performed while a nonresident.

If the *Jones* case, discussed above, retains any vitality as a precedent other than on the exact point the taxpayer there unsuccessfully argued, it must be confined to cases of residents. The policy of the law will not support the complete exemption from tax of annuity contracts received as compensation by residents. It will, however, in the case of nonresidents. The decision below, in failing to give effect to the plain policy of Section 116(a), deprives appellant of its benefit, and does so improperly. Appellant should not now be taxed on capital which became his while he was a nonresident.

CONCLUSION.

The judgment below should be reversed.

Dated, San Francisco, California,
December 3, 1951.

Respectfully submitted,
Arthur H. Kent,
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(Appendix Follows.)

Appendix.

Appendix

INTERNAL REVENUE CODE.

Section 22(a):

(a) *General Definition.* "Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including personal service as an officer or employee of a State, or any political subdivision thereof, or any agency or instrumentality of any one or more of the foregoing), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. In the case of Presidents of the United States and judges of courts of the United States taking office after June 6, 1932, the compensation received as such shall be included in gross income; and all Acts fixing the compensation of such Presidents and judges are hereby amended accordingly. In the case of judges of the courts of the United States who took office on or before June 6, 1932, the compensation received as such shall be included in gross income.

Section 22(b)(2)(A) and (B):

(b) *Exclusions from Gross Income.*—The following items shall not be included in gross income and shall be exempt from taxation under this chapter:

*   *   *   *   *   *   *

(2) *Annuities, etc.*—

(A) *In General.*—Amounts received (other than amounts paid by reason of the death of the insured and interest payments on such amounts and other than amounts received as annuities) under a life insurance or endowment contract, but if such amounts (when added to amounts received before the taxable year under such contract) exceed the aggregate premiums or considration paid (whether or not paid during the taxable year) then the excess shall be included in gross income. Amounts received as an annuity under an annuity or endowment contract shall be included in gross income; except that there shall be excluded from gross income the excess of the amount received in the taxable year over an amount equal to 3 per centum of the aggregate premiums or consideration paid for such annuity (whether or not paid during such year), until the aggregate amount excluded from gross income under this chapter or prior income tax laws in respect of such annuity equals the aggregate premiums or consideration paid for such annuity. In the case of a transfer for a valuable consideration, by assignment or otherwise, of a life insurance, endowment, or annuity contract, or any interest therein, only the actual value of such consideration and the amount of the

premiums and other sums subsequently paid by the transferee shall be exempt from taxation under paragraph (1) or this paragraph. The preceding sentence shall not apply in the case of such a transfer if such contract or interest therein has a basis for determining gain or loss in the hands of a transferee determined in whole or in part by reference to such basis of such contract or interest therein in the hands of the transferor. This subparagraph and paragraph (1) shall not apply with respect to so much of a payment under a life insurance, endowment, or annuity contract, or any interest therein, as, under section 22(k), is includible in gross income;

(B) *Employees' Annuities.*—If an annuity contract is purchased by an employer for an employee under a plan with respect to which the employer's contribution is deductible under section 23(p)(1)(B), or if an annuity contract is purchased for an employee by an employer exempt under section 101(6), the employee shall include in his income the amounts received under such contract for the year received except that if the employee paid any of the consideration for the annuity, the annuity shall be included in his income as provided in subparagraph (A) of this paragraph, the consideration for such annuity being considered the amount contributed by the employee. In all other cases, if the employee's rights under the contract are nonforfeitable except for failure to pay future premiums, the amount contributed by the employer for such annuity contract on or after such rights become nonforfeitable shall be included in the income of the employee in the year in which

the amount is contributed, which amount together with any amounts contributed by the employee shall constitute the consideration paid for the annuity contract in determining the amount of the annuity required to be included in the income of the employee under subparagraph (A) of this paragraph.

Section 116(a):

In addition to the items specified in section 22(b), the following items shall not be included in gross income and shall be exempt from taxation under this chapter:

(a) *Earned Income from Sources Without the United States.*—

(1) *Foreign Resident for Entire Taxable Year.*—In the case of an individual citizen of the United States, who establishes to the satisfaction of the Commissioner that he is a bona fide resident of a foreign country or countries during the entire taxable year, amounts received from sources without the United States (except amounts paid by the United States or any agency thereof) if such amounts constitute earned income defined in paragraph (3); but such individual shall not be allowed as a deduction from his gross income any deductions properly allocable to or chargeable against amounts excluded from gross income under this subsection.

(2) *Taxable Year of Change of Residence to United States.*—In the case of an individual citizen of the United States, who has been a bona fide resident of a foreign country or countries for a period of at least two years before the date on which he

changes his residence from such country to the United States, amounts received from sources without the United States (except amounts paid by the United States or any agency thereof), which are attributable to that part of such period of foreign residence before such date, if such amounts constitute earned income as defined in paragraph (3); but such individual shall not be allowed as a deduction from his gross income any deductions properly allocable to or chargeable against amounts excluded from gross income under this subsection.

(3) *Definition of Earned Income.*—For the purposes of this subsection, "earned income" means wages, salaries, professional fees, and other amounts received as compensation for personal services actually rendered, but does not include that part of the compensation derived by the taxpayer for personal services rendered by him to a corporation which represents a distribution of earnings or profits rather than a reasonable allowance as compensation for the personal services actually rendered. In the case of a taxpayer engaged in a trade or business in which both personal services and capital are material income producing factors, under regulations prescribed by the Commissioner with the approval of the Secretary, a reasonable allowance as compensation for the personal services rendered by the taxpayer, not in excess of 20 per centum of his share of the net profits of such trade or business, shall be considered as earned income.